IN THE

Supreme Court of the United States

October Term, 1975

No. 75-1782

AFW FABRIC CORP., *et al.*,

Petitioners,

v.

ARNOLD MARSHEL,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Petitioners Concord Fabrics Inc., AFW Fabric Corp., Alvin Weinstein and Frank Weinstein ("petitioners") respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered on February 13, 1976. That judgment reversed an order of the United States District Court for the Southern District of New York which denied respondent's motion for a preliminary injunction against a proposed merger of Concord Fabrics Inc. and AFW Fabric Corp. The motion alleged that the proposed

merger violated Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and the law of the state of New York.

On March 10, 1976, the Court of Appeals denied rehearing en banc in both this case and *Green* v. *Santa Fe Industries, Inc.*, —— F.2d ——, CCH Fed. Sec. L. Rep. ¶95,447 (February 18, 1976), a case that raises issues closely related to the issues here. The Court of Appeals stated, in a single decision that encompassed both this case and *Green*:

> "This Court has denied en banc, not because we believe these cases are insignificant, but because they are of such extraordinary importance that we are confident the Supreme Court will accept these matters under its certiorari jurisdiction as we correctly anticipated in *Eisen* v. *Carlisle & Jacquelin,* 479 F.2d 1005, 1020 (2d Cir. 1973), *vacated,* 417 U.S. 156 (1974).
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> * * *
>
> "Accordingly, we speed these cases on their way to the Supreme Court as an exercise of sound, prudent, and resourceful judicial administration." (28a-29a).*

The two cases are of "extraordinary importance" because the Court of Appeals drastically expanded Section 10(b) and Rule 10b-5 beyond their established scope to invalidate, on undefined federal grounds, two mergers which complied with state law. The petition thus raises significant issues relating to the intrusion of the federal courts into an area of corporate regulation that has traditionally been governed by state statutory and common law.

* Parenthetical numerical references followed by the letter "a" are to pages of the appendices to this petition.

Citations to Opinions Below

The opinion of the Court of Appeals for the Second Circuit, dated February 13, 1976, has not yet been reported officially; it is reported unofficially at CCH Fed. Sec. L. Rep. ¶95,448. The decision denying rehearing en banc has not yet been reported officially; it is reported unofficially at CCH Fed. Sec. L. Rep. ¶95,472. The opinion of the District Court for the Southern District of New York dated June 24, 1975, denying plaintiff-respondent Arnold Marshel's motion for a preliminary injunction, is reported officially at 398 F. Supp. 734 and unofficially at CCH Fed. Sec. L. Rep. ¶95,219.

The opinions of the Court of Appeals and the District Court are set forth in Appendices A, B and D to this petition.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit sought to be reviewed was dated and entered on February 13, 1976, and is set forth in Appendix C hereto. By decision dated and entered on March 10, 1976, the Court of Appeals denied rehearing en banc. The Court's decision and order denying rehearing are set forth in Appendix D hereto. Time for filing this petition for certiorari was extended to June 8, 1976 by order of Mr. Justice Marshall, dated April 29, 1976, in accordance with 28 U.S.C. §2101(c).

This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

Questions Presented

1. Did the Court of Appeals improperly expand Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, by enjoining a merger as a "fraud" despite the fact that all the terms, purposes and consequences of the merger and all the material facts relating thereto were fully disclosed to shareholders and there was no misrepresentation, omission or deception?

2. Did the Court of Appeals improperly expand Section 10(b) and Rule 10b-5 into an area traditionally governed by state corporate law by enjoining a merger as a "fraud" despite the absence of any deception and despite the validity of the merger under the law of the state of incorporation?

Statutes and Rule Involved

The federal statute and rule involved here are Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 thereunder, 17 C.F.R. §240.10b-5. The state statutes involved are Sections 623, 902, 903 and 910 of the New York Business Corporation Law, which govern long-form mergers and appraisal proceedings. District Court jurisdiction is conferred by Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. §78aa. These statutes and Rule 10b-5 are set forth in Appendix E.

Statement of the Case

The relevant facts are not in dispute. Concord Fabrics Inc. ("Concord") is a New York corporation in the business of developing, designing and styling fabrics for sale to apparel manufacturers and at retail. (82).* Prior to July, 1968, Concord was a private corporation owned by defendants Alvin and Frank Weinstein and members of their families. (68-69). In that month, Concord made an underwritten public offering of 300,000 shares of its common stock at $15 per share and about one year later, in June, 1969, Alvin and Frank Weinstein sold to the public through underwriters 200,000 shares of common stock at $20 per share. As a result, the public held 32% of Concord's outstanding stock and the Weinsteins held 68%. (68-69).

Almost six years later, on February 6, 1975, Concord announced a plan to return the corporation to private ownership by the Weinstein family. (68-69). The first step in the plan was a tender offer in which AFW Fabric Corp. ("AFW"), a New York corporation which had been formed to carry out the plan, offered to pay $3 per share for each share of Concord's common stock held by the public. (68-69). The second step was to be a long-form merger of AFW and Concord, in which all remaining public shareholders (other than those who elected to assert their appraisal rights) would be paid $3 per share. (68-69). Upon consummation, the Weinstein family would own all of Concord's outstanding stock. (68). Under the provisions of

* Parenthetical numerical references are to the Appendix on appeal in the Second Circuit which is Document I of the certified record transmitted to this Court.

Section 903 of the New York Business Corporation Law, a two-thirds vote of Concord's shareholders was required to approve the merger and, under the provisions of Sections 910 and 623, all dissenting shareholders had the right to a judicial determination of the value of their shares in an appraisal proceeding. (32a-43a).*

The tender offer was withdrawn following the institution of this action which sought to enjoin it. (69). Concord then proceeded with the merger. The terms and consequences of the merger were set forth in a proxy statement mailed to Concord's shareholders approximately one month prior to the meeting to vote on the merger. The price to be paid to shareholders had been determined by Concord's board of directors which relied, in part, on the opinion of Shearson Hayden Stone Inc., a large, well-known investment banking firm, that $3 per share was a fair price for the stock. (72). This price was 70% higher than the highest market price prevailing until three days before the tender offer was announced. (81).

On February 28, 1975, Arnold Marshel ("Marshel") commenced this action in the District Court for the Southern District of New York to enjoin the tender offer. The Court's jurisdiction was based on Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. §78aa. When AFW withdrew the tender offer, Marshel amended his complaint to challenge the merger. The amended complaint (4-32) seeks damages and to enjoin the merger on the ground that

* Unlike the situation in *Green* v. *Santa Fe Industries, Inc., supra,* the proposed merger here was fully and accurately disclosed to Concord's shareholders prior to the date on which the merger was to be consummated. Any dissatisfied shareholder, therefore, could seek to enjoin the merger in the state court.

it constituted a plan to "freeze-out" the public shareholders for no valid corporate purpose at an unreasonably low price. For those reasons, Marshel claimed that the plan violated Rule 10b-5, and was inconsistent with the fiduciary duties of the Weinsteins to Concord's public shareholders under New York common law. The amended complaint did not allege that the proxy statement contained any material misstatements or omissions.*

The District Court denied Marshel's motion for a preliminary injunction. The District Court found that the proxy statement fully and accurately disclosed the terms, purposes and consequences of the merger and was not misleading. (21a-22a). The Court concluded that Marshel's allegations did not state a claim under Rule 10b-5 (21a):

> "Plaintiffs' claims that there has been a Rule 10b-5 violation because of the unfair and inadequate price to be paid for the Concord shares and the absence of a bona fide corporate purpose for the merger are patently without merit. Rule 10b-5 simply does not encompass these alleged wrongs."

The District Court also concluded that Marshel's state law claims were "equally without merit", and that since the merger complied with the New York statute, appraisal was the only remedy available to dissenting shareholders. (22a).

* A second action, *Barry L. Swift* v. *Concord Fabrics Inc., et al.,* alleging jurisdiction based on diversity of citizenship, 28 U.S.C. §1332 (a), and contending that the proposed merger violated New York common law, was filed in the District Court. (141-156). When that Court held the state law claim, as well as the federal claim, was without merit, the *Swift* action was appealed to the Court of Appeals along with the *Marshel* action. Since the Court of Appeals expressly declined to adjudicate the state law claim (6a), which is the sole claim raised in the *Swift* action, the parties to that action have no interest in the outcome of this petition and pursuant to Rule 21(4) of this Court they have not been designated as parties in this proceeding.

Approximately one month after Marshel filed his action, the Attorney General of the State of New York commenced an action in the New York courts to enjoin the proposed merger on the ground that it violated the provisions of the New York blue sky law or Martin Act—Article 23-A of the General Business Law. The New York Supreme Court granted the Attorney General's motion for a preliminary injunction. The New York Court did not find that the proxy statement was misleading or omitted any material facts. Nor did the Court find that the defendants had violated any fiduciary duty, or even that the merger would violate the statute. It thus appears that the injunction was granted merely to permit the State Attorney General to further "scrutinize" the transaction. (51a). (A copy of the opinion is set forth as Appendix F.) The defendants in the state action, Alvin and Frank Weinstein, Concord, AFW and David R. Caplan, the president of Concord, appealed and the Appellate Division affirmed, without opinion and over a vigorous dissent. The foregoing defendants then sought and were granted permission to appeal to the New York Court of Appeals but because of the duration of the process and the adverse effect on Concord's long-term planning, the merger was terminated by mutual consent on February 10, 1976. Thereafter, these defendants signed a consent decree in which they specifically denied the allegations of the complaint and agreed not to consummate the proposed merger or any transaction which violates the Martin Act. Nevertheless, petitioners remain liable in the instant action for potential damages based on the Second Circuit's decision.

In the instant case, Marshel appealed to the Court of Appeals for the Second Circuit from the District Court's

order denying his motion for a preliminary injunction. On February 13, 1976, the Court of Appeals handed down its decision reversing the order of the District Court. The Court of Appeals did not consider the District Court's finding that the merger was valid under state law nor did it disagree with the District Court's conclusion that there had been no misrepresentation, omission of a material fact or deception. The Court of Appeals, nevertheless, concluded that the merger constituted an " 'act, practice, or course of business which operates or would operate as a fraud * * *' " within the meaning of Rule 10b-5. (9a). In reaching its conclusion, the majority did not articulate any standard by which it enjoined the proposed transaction or by which it determined that there was injury to the minority shareholders. The basis for the adverse ruling was stated as follows (9a):

> "We hold that when controlling stockholders and directors of a publicly-held corporation cause it to expend corporate funds to force elimination of minority stockholders' equity participation for reasons not benefiting the corporation but rather serving only the interests of the controlling stockholders such conduct will be enjoined pursuant to Section 10(b) and Rule 10b-5 * * *."

Judge Smith declined to join in the majority's holding that the merger violated Rule 10b-5 because of the Court of Appeals' prior holding in *Popkin* v. *Bishop,* 464 F.2d 714 (1972). He concurred in the result on the ground that the merger constituted a breach of fiduciary duty under New York common law (12a), but did not cite any New York case in support of his conclusion and did not refer to the controlling New York precedents which the District Court

had relied on as establishing the validity of the merger under New York law.

On March 10, 1976, the Court of Appeals denied rehearing en banc in this case and in *Green* v. *Santa Fe Industries, Inc., supra.*

Reasons for Granting the Writ

In denying rehearing en banc, the Court of Appeals for the Second Circuit characterized this case as one of "extraordinary importance" in which "Supreme Court resolution is inevitable * * *." (28a-29a). The importance of the case stems from the Court of Appeals' dramatic and unprecedented expansion of the scope of Section 10(b) and Rule 10b-5 into the field of corporate law which traditionally has been governed by state law.

Heretofore, the provisions of Section 10(b) and Rule 10b-5 had been interpreted as requiring full and accurate disclosure in connection with securities transactions, so that without some misrepresentation or omission of a material fact, or some other form of deception, there could be no violation of Section 10(b) and Rule 10b-5. In this case, however, the Court of Appeals held that full disclosure is not enough and that misrepresentation, omission or deception is not essential to a violation of Rule 10b-5. Rather the Court ruled that Section 10(b) and Rule 10b-5 establish "fiduciary obligations" of majority shareholders to minority shareholders, and require that there be a "valid corporate purpose" underlying transactions between controlling shareholders and their corporations. (10a). The effect of

this holding that Rule 10b-5 encompasses standards of fiduciary conduct and requirements of business purpose will be to make every corporate transaction involving the purchase or sale of securities subject to a federal securities fraud action.

This dramatic expansion of Section 10(b) and Rule 10b-5 is contrary to the recent pronouncements of this Court and the decisions of the Courts of Appeals in the Second and Fifth Circuits. In *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723 (1975), this Court limited the class of plaintiffs having standing to sue under Section 10 (b) and Rule 10b-5 to actual purchasers or sellers of securities. In reaching that result the Court stated that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." 421 U.S. at 739. The Court, as a result, expressed serious concern over the adverse effects of ever-broadening civil liability under Rule 10b-5. 421 U.S. at 739-41 and 747-48.

During this term, in *Ernst & Ernst* v. *Hochfelder,* —— U.S. ——, 44 U.S.L.W. 4451 (March 30, 1976), this Court again limited the scope of Section 10(b) and Rule 10b-5, in a manner which is inconsistent with the Court of Appeals' holding in the instant case. The Supreme Court held in *Ernst & Ernst* that scienter is a necessary element of any violation of those provisions and defined the term to mean a "mental state embracing intent to deceive, manipulate, or defraud." —— U.S. at —— n.12, 44 U.S.L.W. at 4454 n.12. In reaching that conclusion the Court stated that "The 1934 Act was intended principally to protect investors against manipulation of stock prices * * * and to impose regular

reporting requirements" on listed companies. —— U.S. at ——, 44 U.S.L.W. at 4454. Furthermore, it construed the term "manipulative" in the context of Section 10(b) as a "term of art" the essence of which is deception:

> ["Manipulative"] . . . connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." —— U.S. at ——, 44 U.S.L.W. at 4456.

Surely there can be no "intent to deceive, manipulate or defraud," and therefore no scienter, where, as here, the transaction complies with and is valid under state law, and there is full and accurate disclosure and no deception.

The Court of Appeals for the Fifth Circuit has also concluded that full disclosure is the objective that Congress sought to achieve in enacting Section 10(b), and that misrepresentation or omission of a material fact is thus a necessary element of a violation of those provisions. In *Bailes* v. *Colonial Press, Inc.*, 444 F.2d 1241, 1246 (5th Cir. 1971), the Court of Appeals stated that "the gravamen of a 10b-5 cause of action is deception", and in *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970), the same court described the purpose of Congress in enacting Section 10(b) as the elimination of manipulation by assuring that investors have sufficient information to make knowing and intelligent decisions:

> "In short, Congress meant to afford investors a reasonable opportunity to make knowing, intelligent decisions regarding their purchases and sales of securities in unmanipulated markets, and the loss resulting in connection with purchases or sales made without benefit of such an opportunity is the type of injury Section 10(b) and Rule 10b-5 seek to prevent." *Id.* at 806 (citations omitted).

Significantly, the decisions of the Second Circuit itself contain the clearest statements of the necessity for deception, and are in direct and irreconcilable conflict with the Court's decision here. *Popkin* v. *Bishop*, 464 F.2d 714 (2d Cir. 1972), squarely held that full disclosure to shareholders precluded a violation of Section 10(b) and Rule 10b-5, and is directly in point. In *Popkin*, as here, there was a long-form merger which, under state law, was required to be approved in advance by shareholders, with the majority shareholders having sufficient votes to assure approval. Futhermore, as here, there was concededly full and accurate disclosure with respect to the merger which enabled the shareholders to seek to enjoin the transaction under state law. The Court rejected the claim that a breach of fiduciary duty was actionable under Rule 10b-5, concluding that full disclosure satisfied the federal interest and precluded a violation of Section 10(b) and Rule 10b-5 (464 F.2d at 719-20):

> "Thus, it seems clear that our emphasis on self-dealing did not eliminate non-disclosure as a key issue in Rule 10b-5 cases. Section 10(b) of the Exchange Act and Rule 10b-5 are designed principally to impose a duty to disclose and inform rather than to become enmeshed in passing judgments on the information elicited. This design has special relevance to merger transactions that, under state law, must be subjected to shareholder approval. In the context of such transactions, if federal law ensures that shareholder approval is fairly sought and freely given the principal federal interest is at an end. Underlying questions of the wisdom of such transactions or even their fairness become tan-

gential at best to federal regulation. * * *" (Citations omitted).

Accord, O'Neill v. *Maytag,* 339 F.2d 764 (2d Cir. 1964).

The sweeping consequences of the decision below that full disclosure is no longer sufficient and that Section 10 (b) and Rule 10b-5 embody fiduciary obligations and standards of corporate purpose can be clearly foreseen. Every corporate merger or consolidation, and virtually every corporate purchase or sale of assets, will become subject to challenge under Rule 10b-5 on the ground of the unfairness or inadequacy of the consideration, or of possible benefit to insiders, or of the adequacy of the corporate purpose, or on any other substantive ground which the ingenuity of the parties may produce. The result will inevitably be a flood of litigation under Section 10(b) and Rule 10b-5 in the federal courts and a dramatic expansion of civil liability under those provisions—the precise results that this Court sought to avoid in *Blue Chip.* Absent a definitive decision by this Court, that flood is likely to be concentrated in the Second Circuit, which stands alone in applying Section 10 (b) and Rule 10b-5 to enjoin a transaction in which there has been full and accurate disclosure to shareholders.

The Court of Appeals' construction of Section 10(b) and Rule 10b-5 also is "extraordinarily significant" because of its effect on state law and federal-state relationships. The Court of Appeals applied these provisions to invalidate as a matter of federal law a transaction that the District Court held to be in full compliance with state law.* The proposed merger fully complied with the provisions of Section 902(a)(3) of the New York Business Corporation Law which expressly authorizes a merger where, as here, the stock of one of the constituent corporations is to be converted into cash. (41a). The statute contains no requirement of a business purpose where two corporations are merged. As the District Court pointed out, two decisions of the New York Court of Appeals hold that a minority shareholder has no right to retain his shareholder status, and that his sole right is to receive the fair value of his shares in an appraisal proceeding. *Beloff* v. *Consolidated Edison Co.,* 300 N.Y. 11, 19, 87 N.E.2d 561, 564 (1949); and *Willcox* v. *Stern,* 18 N.Y.2d 195, 202, 273 N.Y.S. 2d 38, 43, 219 N.E.2d 401, 404 (1966). The Court of Appeals expressly refused to consider the validity of the merger under New York law, and held that it violated some undefined fiduciary duty of the majority shareholders to the minority, and therefore, without more, was a "fraud" enjoinable under Rule 10b-5.

* This result raises serious questions as to whether the Court's interpretation of Section 10(b) and Rule 10b-5 is consistent with the spirit, if not the letter, of *Erie R.R. Co.* v. *Tompkins,* 304 U.S. 64 (1938). *See* Borden, *Going Private—Old Tort, New Tort or No Tort?,* 49 N.Y.U.L. Rev. 987, 1039 (1974).

In concluding that Section 10(b) and Rule 10b-5 contain a substantive federal law of corporations which overrides state law, and that Rule 10b-5 may be applied to designate as a "fraud", and to enjoin, a transaction which has been held by the District Court to be valid under state law, the Court of Appeals has upset the delicate balance of federal-state relations in the field of corporate law. Until this decision, state law had governed internal corporate affairs and the rights and duties of shareholders and management; whereas the role of federal law had been to insure full and accurate disclosure. That balance should not be disturbed absent a clear expression of congressional

intent to do so. As the Court of Appeals for the Fifth Circuit stated:

> "If Congress had intended that the federal courts inquire into every decision affecting the management of corporations and then fashion a new federal law superseding state law on the fiduciary responsibilities of corporate directors, officers and controlling persons, presumably so revolutionary a federal intervention into an area traditionally handled by the states would have been clearly expressed." *Herpich* v. *Wallace,* 430 F.2d 792, 809 (5th Cir. 1970) (citations omitted).

Section 10(b) reflects no congressional intent to authorize such a "revolutionary intervention into an area traditionally handled by the states."

Furthermore, since the Court of Appeals invalidated as a matter of federal law a transaction that the District Court held complies with state law, businessmen and corporate lawyers no longer can rely on the well-developed body of state law in planning corporate transactions. Indeed, a single corporate transaction may well be subjected to conflicting federal and state substantive as well as procedural requirements. This in turn will subject directors and controlling shareholders to different standards of liability, depending upon whether the transaction is challenged in federal or state court. Finally, in view of the fact that state law has been superseded by a federal substantive law of corporations, states might well "abandon their creative and effective role in this area of the law." *Kaminsky* v. *Abrams,* 281 F. Supp. 501, 505 (S.D.N.Y. 1968).*

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* The applicability of federal and state law to transactions for the purpose of transforming public corporations into private corporations has been the subject of much scholarly comment and controversy. *See, e.g.,* Borden, *Going Private—Old Tort, New Tort or No Tort?,* 49 N.Y.U.L. Rev. 987 (1974); Note, *Going Private,* 84 Yale L. J. 903 (1975); and 3 A. Bromberg, Securities Law: Fraud §4.7 (1975).

Certainly, such a drastic expansion of the scope of liability under Section 10(b) and Rule 10b-5 and such a significant change in federal-state relationships should not be permitted without review by this Court.

Conclusion

For these reasons, the writ of certiorari should issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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APPENDICES

Appendix A

Opinion of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 239—September Term, 1975

(Argued September 4, 1975 Decided February 13, 1976.)

Docket No. 75-7404

ARNOLD MARSHEL,
Plaintiff-Appellant,

v.

AFW FABRIC CORP., CONCORD FABRICS INC., ALVIN WEINSTEIN and FRANK WEINSTEIN,
Defendants-Appellees.

BARRY L. SWIFT,
Plaintiff-Appellant,

v.

CONCORD FABRICS INC., AFW FABRIC CORP., ALVIN WEINSTEIN and FRANK WEINSTEIN,
Defendants-Appellees.

Before:

SMITH, HAYS and MESKILL,
Circuit Judges.

Appeal from an order of the United States District Court for the Southern District of New York, Lloyd F.

MacMahon, *Judge,* denying motions made pursuant to Rule 65 of the Federal Rules of Civil Procedure for a preliminary injunction against a proposed merger.

Reversed.

MARTIN A. COLEMAN, New York, New York (Rubin, Baum, Levin, Constant & Friedman, New York, New York, on the brief), *for Appellant Marshel.*

BURTON L. KNAPP, New York, New York (Lipper, Lowey & Dannenberg, New York, New York, on the brief), *for Appellant Swift.*

SIDNEY J. SILBERMAN, New York, New York (Kaye, Scholer, Fierman, Hays & Handler, New York, New York, on the brief, Milton Sherman, of counsel), *for Appellees.*

HAYS, *Circuit Judge:*

Arnold Marshel and Barry L. Swift appeal from an order of the United States District Court for the Southern District of New York, denying appellants' motions for a preliminary injunction against a proposed merger between Concord Fabrics, Inc. ("Concord") and AFW Fabric Corp. ("AFW") both of which are incorporated under the laws of New York. Appellants, stockholders of Concord, seek to enjoin the proposed merger on the grounds, *inter alia,* that it would violate Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) (1970), and Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5 and New York law. We reverse the district court's order.

I

Prior to July, 1968 Concord was a private corporation owned entirely by defendants Alvin and Frank Weinstein and various family trusts. At that time Concord made an initial public offering of 300,000 shares of common stock at $15 per share realizing net proceeds of approximately $4,100,000. About one year later Alvin and Frank Weinstein publicly sold 200,000 additional shares for their own accounts at a price of $20 per share. Net proceeds to the Weinsteins were approximately $3,700,000. As a result of the public offerings the Weinsteins now own approximately 68% of Concord's outstanding stock while the remaining 32% is publicly held. Since June, 1969 the publicly owned shares have been listed for trading on the American Stock Exchange. Concord had approximately 1,000 public stockholders throughout the United States.

Concord is engaged in the textile fabric business. Since becoming a public company its earnings have fluctuated considerably. Record high earnings achieved in 1968 and 1969 dropped sharply in 1970. In 1971 and 1972 severe losses were incurred. Since then the company's operations have been moderately successful. Concord stock has traded at prices between a high of $25 per share in 1969 and a low of $1 per share in late 1974.

In January, 1975 the Weinsteins initiated a plan to eliminate the public stockholders of Concord and return the company to the private ownership of the Weinstein family. As the first step toward this objective, the individual defendants organized AFW and transferred to it 1,226,549 Concord shares representing their 68% owner-

ship of Concord. In exchange for the Concord stock the Weinsteins received 100% of AFW's stock. AFW performs no function other than acting as the corporate vehicle for the Weinstein's stock interest in Concord. The next step on the road to "going private" came on February 6 when AFW made a tender offer for all the publicly held Concord shares at a price of $3 per share. This purchase was to be financed through bank loans to AFW which would ultimately become the obligations of Concord. AFW's Offer to Purchase stated that after the offer expired AFW would cause a merger between itself and Concord regardless of whether any shares were tendered. Under the terms of the proposed merger the Weinsteins, as sole stockholders of AFW, would receive all the stock of the surviving company while the Concord stock held by the public would be cancelled with each stockholder entitled to receive $3 per share of cancelled stock. The Offer to Purchase also stated that since AFW owned more than the percentage of Concord's stock required to consummate the merger under New York law, stockholders who did not tender their shares would be unable to prevent the subsequent merger by voting against it at the shareholders' meeting. According to the offer AFW expected the merger to be completed in April, 1975.

On February 28, 1975 Marshel commenced a shareholder's derivative and class action in the United States District Court for the Southern District of New York seeking to enjoin the AFW tender offer. Appellant Swift brought an action in the Supreme Court of the State of New York seeking the same relief as Marshel. On March

3 the defendants withdrew the Offer to Purchase and returned all Concord shares which had been tendered in response to it. They pursued the plan of merger between Concord and AFW however, mailing to the public Concord shareholders on March 17, 1975 a Proxy Statement and Notice of Special Meeting of Shareholders of Concord for the purpose of acting upon the merger. Favorable shareholder approval was, as stated in the proxy materials, a foregone conclusion given the Weinsteins' 68% ownership of Concord. Moreover, the lack of any corporate purpose for the merger was clearly revealed in the proxy statement.

> "The purpose of the proposed merger of AFW into the Company [Concord] is to return the Company to the status of a privately-held corporation owned by the Weinstein family. Upon consummation of the merger, the Weinsteins will be the sole stockholders and directors of the Company, and will thus be able to determine all policies of the Company, such as salaries for themselves and others, dividends and business activities, without public scrutiny and solely with regard to their own interests."

After the tender offer was withdrawn, Marshel amended his complaint to include a challenge to the merger. Swift discontinued his state court suit and filed a complaint in the federal court seeking, like Marshel, to enjoin the merger.[1] Marshel's complaint contains class action and

1. Two other shareholder injunctive suits attacking the proposed merger between Concord and AFW were brought in the district court. *Michaels* v. *Weinstein*, 75 Civ. 1027; *Krause* v. *Concord Fabrics, Inc.*, 75 Civ. 1064. All four actions were consolidated and heard by Judge MacMahon. *Marshel* v. *AFW Fabric Corp.*, 398 F.Supp. 734 (S.D. N.Y. 1975). Only the Marshel and Swift actions are the subject of this joint appeal.

derivative counts relating to the proposed merger alleging various violations of the Securities Exchange Act of 1934, 15 U.S.C. §78a *et seq.* (1970), and the Rules and Regulations of the S.E.C. promulgated thereunder. Jurisdiction is based upon Section 27 of the Act, 15 U.S.C. §78aa (1970). Marshel also asserts pendent claims of fraud and breach of fiduciary duties by defendants under New York law. Jurisdiction in the Swift action is based upon diversity of citizenship, 28 U.S.C. §1332(a), and the allegations in the complaint raise issues identical to the pendent claims in the Marshel action. Since we find that the challenged conduct constitutes a violation of Section 10(b) and Rule 10b-5 we do not reach the state law claims.

II

Appellants contend that unless a legitimate corporate purpose of Concord is furthered by elimination of the minority public shareholders the proposed merger may not be allowed to proceed. Appellees concede there is no such underlying purpose served here. They admit AFW was organized solely as a vehicle to effectuate, in essence, a forced cash repurchase by Concord of its public stockholders' shares at a time and price determined entirely by the controlling stockholders and for their sole benefit. AFW has no function other than as a device facilitating the Weinsteins' attempt to utilize the state merger statute to accomplish indirectly what would be impossible to achieve through normal corporate processes because of settled law prohibiting the elimination of minority shareholders by vote of the majority.[2] See *Bryan* v. *Brock &*

2. While New York has a statute permitting the "freeze-out" of splinter minority interests, N.Y. Business Corporation Law §905 (McKinney Supp. 1975), the majority stockholder must own at least 95% of the corporation's share in order to employ this provision. See *Wilcox* v. *Stern*, 18 N.Y.2d 195, 273 N.Y.S.2d 38 (1966); *Beloff* v. *Consolidated Edison Co.*, 300 N.Y. 11 (1949).

Blevins Co., 490 F.2d 563 (5th Cir.) cert. denied, 419 U.S. 844 (1974); cf. *Lebold* v. *Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1941).

Appellees nevertheless argue that absence of any corporate purpose is irrelevant because the proposed merger would comply in all respects with the requirements of the merger statute, N.Y. Business Corporation Law §901 *et seq.* (McKinneys Supp. 1975), and, under that statute, appraisal rights are the exclusive remedy provided for dissenting shareholders. Whether the challenged merger is valid under state law[3] is an issue we do not decide. However, in determining the applicability of the federal securities law, we must look through the technical form to ascertain the substance of the transaction. What this purported "merger" amounts to is a scheme by the appellees, having previously taken advantage of public financing, to appropriate for their personal benefit the entire stock ownership of Concord at a price determined by them and paid out of the corporate treasury at a cost of over $1,600,000.[4] Such conduct is proscribed by the language of

3. We note however that the proposed merger has been enjoined in state court proceedings commenced by the Attorney General of the State of New York under the Martin Act, N.Y. General Business Law §352 (McKinney 1967). *People* v. *Concord Fabrics, Inc.*, N.Y. L.J., June 13, 1975 at p. 15.

4. The proxy materials reveal the effect of the merger on the Weinstein family:

> "The effect of the proposed merger will also be that without any additional investment on the part of the Weinstein family their interest in the stockholder's equity of the Company will be increased from approximately $9,494,000 (representing 68% of equity as at February 2, 1975) to approximately $12,285,000

(footnote continued on next page)

Section 10(b)[5] and Rule 10b-5.[6] We do not regard the existence of the state appraisal remedy as negating the appellants' rights under federal law. *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6, 12 (1971); *Vine* v. *Beneficial Finance Co.,* 374 F.2d 627, 635-36 (2d Cir.), cert. denied, 389 U.S. 970 (1967). "Where Rule 10b-5 properly extends, it will be applied regardless of any cause of action that may exist under state law." *Popkin* v. *Bishop,* 464 F.2d 714, 718 (2d Cir. 1972). Furthermore,

(representing 100% of such equity on a pro forma basis, giving effect to consummation of the merger * * *) and their interest in the Company's net earnings for the fiscal year ended September 1, 1974 will increase from approximately $354,000 (68% of such earnings) to approximately $442,000, being 100% of such earnings on a pro forma basis. * * *"

5. Section 10 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

6. "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

"in connection with the purchase or sale of any security."

as we stated in *Popkin,* a controlling shareholder's "ability to push through the merger—with or without any other shareholder's vote—cannot by itself defeat a claim for federal injunctive relief." 464 F.2d at 718. We hold that when controlling stockholders and directors of a publicly-held corporation cause it to expend corporate funds to force elimination of minority stockholders' equity participation for reasons not benefiting the corporation but rather serving only the interests of the controlling stockholders such conduct will be enjoined pursuant to Section 10(b) and Rule 10b-5 which prohibits "any act, practice, or course of business which operates or would operate as a fraud * * * in connection with the purchase or sale of any security."

In *Drachman* v. *Harvey,* 453 F.2d 732, 736-38 (2d Cir. 1972) (rehearing en banc) shareholders in Harvey Aluminum, Inc. brought a derivative action seeking damages for losses allegedly suffered when the controlling shareholder of Harvey, Martin Marietta Corporation, caused an improvident redemption of an outstanding issue of Harvey's convertible debentures in order to prevent their possible conversion and consequent dilution of Martin Marietta's voting control. This Court held that a sufficient claim of fraud against the corporation in connection with a purchase of securities had been stated within the meaning of §10(b) and Rule 10b-5. See also, *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* supra; *Schoenbaum Insurance* v. *Firstbrook,* 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied sub nom., *Manley* v. *Schoenbaum,* 395 U.S. 906 (1969); *Hooper* v. *Mountain State Securities Corp.,* 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S.

814 (1961). In *Schoenbaum* it was alleged that the Aquitane Company of Canada, Ltd., the controlling shareholder of Banff Oil, Ltd., exercised a controlling influence over the issuance to it of Banff treasury stock for a wholly inadequate consideration. This Court held that, if established, the transaction constituted a violation of Rule 10b-5.

In the instant case a similar situation presents itself. The controlling shareholders of Concord have devised a scheme to defraud their corporation and the minority shareholders to whom they owe fiduciary obligations by causing Concord to finance the liquidation of the minority's interest with no justification in the form of a valid corporate purpose. The federal securities law does not confer jurisdiction for instances of corporate mismanagement or self-dealing absent fraud intrinsic to a securities transaction. Here, however, a purchase and sale of securities is at the heart of the fraudulent scheme. See, e.g., *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* supra at 10-13 (1971); *Schlick* v. *Penn-Dixie Cement Corp.,* 507 F.2d 374, 379-80 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975); *A.T. Brod & Co.* v. *Perlow,* 375 F.2d 393, 397 (2d Cir. 1967); *Ruckle* v. *Roto American Corp.,* 339 F.2d 24, 29 (2d Cir. 1964).

III

The district court denied plaintiffs' motions for a preliminary injunction on the ground that since defendants had disclosed all material facts concerning the merger to the minority shareholders in the proxy statement, a cause of action based on §10(b) and Rule 10b-5 was precluded by this Court's decision in *Popkin* v. *Bishop,* supra. *Popkin* is inapposite. There a derivative action was brought to

enjoin a merger on the grounds that the exchange ratios for the conversion of the common stock of the merging corporations into the stock of the surviving corporation were "unfair" to plaintiff. 464 F.2d at 717. The propriety of the merger itself was not challenged.[7] Since the complaint contained "no allegation or hint of any misrepresentation by defendants or of a failure on their part to disclose any material fact in connection with the merger proposal," 464 F.2d at 718, its dismissal was upheld by this Court because no fraud had been stated. Compare *Schlick* v. *Penn-Dixie Cement Corp.,* supra. In the present case the "merger" itself constitutes a fraudulent scheme because it represents an attempt by the majority stockholders to utilize corporate funds for strictly personal benefit. Under these circumstances it would surely be anomalous to hold that a cause of action is stated under §10(b) and Rule 10b-5 when the fraudulent conduct in connection with a purchase or sale of securities includes deception but that similarly fraudulent practices carried out with prior disclosure to the helpless victim do not give rise to a Rule 10b-5 claim. Neither the statutory language nor the broadly remedial purposes of the Act, see, e.g., *Tcherepnin* v. *Knight,* 389 U.S. 332, 336 (1967), allow such a distinction.

SMITH, *Circuit Judge* (concurring):

I concur. I find it difficult to reconcile the 10(b) basis of the holding with the opinion in *Popkin* v. *Bishop,* 464 F. 2d 714 (2d Cir. 1972). However, this case illustrates the

7. In fact, it appears that the merger was required by the terms of a Stipulation of Settlement filed in an earlier lawsuit. 464 F.2d at 716.

opportunities for fraudulent treatment of securities holders in corporations "going private" for no legitimate corporate purpose even though with full, even brazen disclosure. It casts doubt on the desirability of a "full disclosure" bar in all situations. In any case, grant of the injunction here is sustainable on the ground of breach of the fiduciary duty under New York law of the majority shareholders in their admitted self-dealing. Compare, *Bryan* v. *Brock and Blevins Co.*, 490 F.2d 563 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974).

Appendix B

Order of the United States District Court for the Southern District of New York

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

75 Civ. 1018-LFM

ARNOLD MARSHEL,

Plaintiff,

against

AFW FABRIC CORP. *et al.*,

Defendants.

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75 Civ. 1027-LFM

GUY MICHAELS,

Plaintiff,

against

ALVIN WEINSTEIN *et al.*,

Defendants.

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75 Civ. 1064-LFM

JESSE KRAUSE,

Plaintiff,

against

CONCORD FABRICS, INC. *et al.*,

Defendants.

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75 Civ. 1465-LFM

Barry L. Swift,

Plaintiff,

against

Concord Fabrics, Inc.,

Defendants.

Appearances:

Rubin Baum Levin Constant & Friedman, New York City, for plaintiff in 75 Civ. 1018.

Wolf Popper Ross Wolf & Jones, New York City, for plaintiff in 75 Civ. 1027.

Kass, Goodkind, Wechsler & Gersten, New York City, for plaintiff in 75 Civ. 1064.

Lipper, Lowey & Dannenberg and Burton L. Knapp, New York City, for plaintiff in 75 Civ. 1465.

Kaye Scholer Fierman Hays & Handler, New York City, for defendants.

MacMahon, *District Judge.*

Plaintiffs in these four related actions move, pursuant to Rule 65, Fed.R.Civ.P., to enjoin preliminarily the proposed merger between Concord Fabrics, Inc. (Concord) and AFW Fabric Corp. (AFW). Plaintiff Michaels also seeks leave to file an amended complaint. Defendants move for an order consolidating the four actions for all purposes, appointing a general or liaison counsel for plaintiffs, and

staying Concord shareholders from commencing any additional actions based on the proposed merger.

These class and derivative actions arise out of the proposed merger of defendants Concord and AFW. Concord, a converter of fabrics, was, until July 1968, a private corporation owned by defendants Alvin and Frank Weinstein and their families. At that time, 300,000 shares of Concord stock were sold publicly for $15 per share, and in June 1969 the Weinsteins sold 200,000 shares for $20 per share, also pursuant to a public offering. Since then, Concord stock has been listed on the American Stock Exchange.

Concord's earnings in 1968 and 1969 were over $2,000,000 per year, a record level, but its earnings declined sharply in the following two years and have been only moderate ever since. Concord paid dividends from 1968 through the first quarter of 1970. Since then, no dividends have been paid.

Concord stock was selling at a high of $25 per share in early 1969 but has steadily declined until it dropped to a low of about $1 per share in late 1974. This decline is attributable to a discontinuance of the company's dividends, declining earnings and general stock market decline. Through March of this year, the price of Concord stock never rose to $3 per share.

In January of this year, the Weinsteins initiated a plan to return Concord to the private ownership of the Weinstein family. As the first step toward this objective, the Weinsteins organized AFW, and, on February 5, 1975, they transferred 1,226,549 Concord shares, representing 68% of the total outstanding stock to AFW. In exchange for the

Concord shares, the Weinsteins received 100% of AFW's stock.

On February 6, 1975, AFW made a tender offer of $3 per share for the publicly-held Concord stock. The Weinsteins planned to follow this tender offer with the merger of AFW into Concord in April 1975. All shareholders remaining at the time of the merger were to receive $3 per share for their Concord shares. The net result of the tender offer and merger would be to return Concord to the private ownership of the Weinstein family.

Concord's board of directors arrived at the $3 per share valuation of Concord's stock following an opinion by the investment banking and brokerage firm of Shearson Hayden Stone, Inc. (Shearson). Shearson advised Concord that $3 was the fair and equitable value of a Concord share.

On February 28, 1975, the first of these related shareholder actions[1] was filed. Plaintiff, in that purported class and derivative action, charges, in essence, that defendants engaged in a scheme and conspiracy to defraud Concord stockholders into selling their shares at an unfair price, in violation of Sections 10(b), 13(d), 14(a), 14(d) and 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. §§78j(b), 78(m)(d), 78n(a), 78n(d) and 78(n)(e), various SEC rules and regulations and New York common law. It is alleged that the offering statement issued in connection with the tender offer contained misleading statements and omitted material facts. The derivative claim alleges that defendants defrauded Concord and its shareholders, breached fiduciary duties owed them and wasted corporate assets. Plaintiff seeks, *inter alia*, to enjoin the tender offer.

1. *Marshel* v. *AFW Fabric Corp.*, 75 Civ. 1018.

The Weinsteins foresaw attempts to enjoin the merger as well as the tender offer, and since the merger alone would accomplish the results they sought, they withdrew the tender offer on March 3, 1975 to avoid unnecessary legal expenses. The Weinsteins' predictions were accurate, for legal proceedings aimed at the merger were not long in coming. The first of these actions[2] was filed on March 3, 1975, and two others soon followed.[3]

The material allegations of the *Michaels* and *Krause* cases are similar. Both of these purported class actions charge violations of Sections 10(b) and 14 of the 1934 Act and common law. Like the *Marshel* action, their thrust is that defendants are defrauding Concord stockholders into selling their shares at an unfair price. They also allege that the offering statement contained certain misstatements and omissions and seek, *inter alia*, to enjoin the tender offer and merger. The *Michaels* action, unlike any of the others, names Shearson as a party defendant.

The last of these four actions, *Swift* v. *Concord Fabrics, Inc.*, a putative class and derivative action, grounds jurisdiction on diversity of citizenship and alleges only violations of New York law. It alleges, in essence, that defendants have conspired, in breach of their fiduciary duties, to eliminate Concord's public shareholders by giving them less than adequate value for their shares under the

2. *Michaels* v. *Weinstein*, 75 Civ. 1027.

3. *Krause* v. *Concord Fabrics, Inc.*, 75 Civ. 1064 (filed March 4, 1975), and *Swift* v. *Concord Fabrics, Inc.*, 75 Civ. 1465 (filed March 24, 1975).

merger of Concord and AFW. The derivative claim charges defendants with wasting Concord's assets and breaching fiduciary duties owed the corporation and its shareholders. Plaintiff seeks, *inter alia,* to enjoin the merger.

Plaintiffs move for preliminary injunctions on the ground that the proposed merger will violate Sections 10(b) and 14 of the 1934 Act and New York law.[4] They contend, essentially, that the merger should be enjoined because it serves no legitimate corporate purpose but is intended only to eliminate public shareholders by giving them inadequate compensation for their shares. As such, they claim, the merger is a device, scheme and artifice to defraud, in violation of Rule 10b-5.

In order for plaintiffs to prevail on their motions for preliminary injunctions, they must demonstrate either a combination of probable success and the possibility of irreparable injury or that they have raised serious questions going to the merits and that the balance of hardships tips sharply in their favor.[5]

Plaintiffs rely on decisions in other circuits holding mergers which eliminate public shareholders without a cor-

4. While certain plaintiffs also challenge the legality of the tender offer under Section 14 of the 1934 Act, we need not address these contentions since the tender offer has since been withdrawn. This does not preclude plaintiffs, certainly, from presenting any claims for damages they may have suffered as a result of the tender offer at a trial on the merits.

5. *Sonesta Int'l Hotels Corp.* v. *Wellington Associates,* 483 F.2d 247 (2d Cir. 1973); *Gulf & Western Indus., Inc.* v. *Great Atl. & Pac. Tea Co.,* 476 F.2d 687 (2d Cir. 1973); *Robert W. Stark, Jr., Inc.* v. *New York Stock Exch., Inc.,* 466 F.2d 743, 744 (2d Cir. 1972); see *Checker Motors Corp.* v. *Chrysler Corp.,* 405 F.2d 319, 323 (2d Cir.), *cert. denied,* 394 U.S. 999 (1969).

porate business purpose violative of Rule 10b-5.[6] The cases in this circuit and in this district, however, are to the contrary.

In *Popkin* v. *Bishop,*[7] plaintiff sought to enjoin the merger of a parent corporation and its subsidiaries into a holding company of the parent corporation on the ground that the merger's exchange ratios were unfair. Plaintiff alleged that defendants breached various fiduciary duties and violated Rule 10b-5. The Court of Appeals affirmed the district court's dismissal of the complaint. In reaching its decision, the court assumed that the exchange ratios were actually unfair. It noted, however, that the complaint failed to allege misrepresentation or failure to disclose any material facts about the merger. The court noted that:

> "Section 10(b) of the Exchange Act and Rule 10b-5 are designed principally to impose a duty to disclose and inform rather than to become enmeshed in passing judgments on information elicited. * * * Underlying questions of the wisdom of such transactions or even their fairness become tangential at best to federal regulation."[8]

The court concluded that injunctive relief under the federal securities laws does not lie when there has been full disclosure of a merger's terms.

6. See *Bryan* v. *Brock & Blevins Co.,* 343 F. Supp. 1062 (N.D. Ga. 1972), *aff'd,* 490 F.2d 563 (5th Cir. 1974); *Albright* v. *Bergendahl,* CCH Fed. Sec. L. Rep. ¶94,997 (D. Utah Sept. 5, 1974). See also *United Funds* v. *Carter Products, Inc.,* CCH Fed. Sec. L. Rep. ¶91,288 (Balt. City Civ. Ct. May 16, 1963).

7. 464 F.2d 714 (2d Cir. 1972).

8. *Popkin* v. *Bishop, supra,* 464 F.2d at 719-20.

In *Dreier* v. *The Music Makers Group, Inc.*,[9] the court dismissed a Rule 10b-5 claim for legal insufficiency in an action to enjoin a merger closely resembling the merger here. There, defendants organized a private corporation and transferred to it 60% of the public corporation's stock. The proposed merger was approved by the public corporation's controlling shareholders. Its terms provided for $3 per share to be paid to the public shareholders. The complaint alleged that the merger's sole purpose was to enrich the controlling shareholders by forcing the minority shareholders to sell at an unfair price. The court held that absent allegations of misrepresentation or nondisclosure, the complaint failed to state a claim under the federal securities laws.

Relying on *Popkin* v. *Bishop, supra,* the *Dreier* court noted that "non-disclosure remains an essential element in any section 10(b)-Rule 10b-5 action. * * * [T]he treatment of the minority shareholders may well have been grossly unfair but it was completely open. Under these circumstances plaintiff's remedy is a state court action for appraisal. * * *" The weight of authority, at least in this circuit, supports this interpretation of Rule 10b-5.[10]

Under this narrow interpretation of Rule 10b-5, plaintiffs' motions here for preliminary injunctions, insofar as they are premised on violations of the federal securities

9. CCH Fed. Sec. L. Rep. ¶94,406 (S.D.N.Y. Feb. 20, 1974).

10. *Green* v. *Santa Fe Indus., Inc.*, 74 Civ. 3915 (S.D.N.Y. Mar. 27, 1975); *Tanzer Economic Associates* v. *Haynie*, 388 F. Supp. 365 (S.D.N.Y. 1974); *Kaufmann* v. *Lawrence*, 386 F. Supp 12 (S.D. N.Y. 1974), *aff'd per curiam*, Docket No. 74-2591 (2d Cir. Apr. 3, 1975). *Cf. Broder* v. *Dane*, 384 F. Supp. 1312 (S.D.N.Y. 1974).

laws, are without merit. Plaintiffs' claims that there has been a Rule 10b-5 violation because of the unfair and inadequate price to be paid for the Concord shares and the absence of a bona fide corporate purpose for the merger are patently without merit. Rule 10b-5 simply does not encompass these alleged wrongs.

Although plaintiffs do allege a myriad of misrepresentations and nondisclosures in connection with the proposed merger, thus lumping their claims within the ambit of Rule 10b-5, we find little factual substance to these allegations. The thrust of plaintiffs' allegations of nondisclosure is that defendants did not disclose the illegality of their actions, *i.e.*, that the merger had no valid business purpose, that the price to be paid for the Concord shares is inadequate, that the Weinsteins are benefitting themselves to the detriment of the public shareholders, and that what is described as a merger is no more than a fraudulent scheme.

The proxy statement, we find, is not misleading. Nor does it fail to disclose any material information. It states expressly that AFW was organized for the purpose of causing Concord to be merged with AFW. It discloses that the Weinsteins transferred 68% of Concord's outstanding stock to AFW and, as AFW's sole owners, intend to vote in favor of the merger. The proxy statement further discloses that the public shareholders will be unable to defeat the merger. Rather, they must accept $3 per share or exercise their appraisal rights. The proxy statement includes financial statements and states that the $3 per share price is based on the opinion of Shearson.

The proxy statement further states that the purpose of the merger is to return Concord to the private ownership of the Weinsteins so that it may be operated solely in their

interests. It also details what effect the merger will have on the financial stituation of the Weinsteins.

Although this is far from an exhaustive summary of the information contained in the proxy statement, it demonstrates that the statement lays bear the facts of, and the motives for, the merger. Plaintiffs have failed to demonstrate that the proxy statement misstates material facts or fails to disclose them. All that the statement appears to omit is plaintiffs' legal conclusion that the merger is illegal. We see no indication, at least at this juncture of the litigation, that the conclusion is well founded.

Accordingly, with respect to the federal claims plaintiffs have failed to demonstrate probable success or serious questions going to the merits. Moreover, the damage to be suffered by plaintiffs, should the merger be consummated and ultimately adjudicated illegal, will not be irreparable since plaintiffs have a "sufficiently adequate remedy at law"[11] in the way of monetary damages. Plaintiffs have likewise failed to demonstrate that the balance of hardships tips in their favor. Preliminary injunctive relief, therefore, must be denied as to the federal claims.

We find plaintiffs' contention that they are entitled to a preliminary injunction for violations of state law equally without merit. Where a merger is to be accomplished in accordance with statutory proceedings, as here,[12] appraisal is the only remedy available to dissenting shareholders.[13]

11. *Tanzer Economic Associates* v. *Haynie, supra,* 388 F. Supp. at 369.

12. See N.Y. Business Corporation Law §§901 et seq. (McKinney 1974 Supp.).

13. *Willcox* v. *Stern,* 18 N.Y.2d 195 (1966); *Beloff* v. *Consolidated Edison Co.,* 300 N.Y. 11 (1949).

> " 'In short, the merged corporation's shareholder has only one real right; to have the value of his holding protected, and that protection is given him by his right to an appraisal. * * * He has no right to stay in the picture, to go along into the merger, or to share in its future benefits. * * *'
>
> The remedy of an appraisal and payments for one's shares affords fair and just compensation to dissenting stockholders while allowing the overwhelming majority to proceed with the merger.' "[14]

Plaintiffs have failed to meet the requirements for a preliminary injunction on the state claims. Their motions must therefore be denied.

Since there is no doubt that these actions all involve common, if not identical, questions of law and fact, defendants' motion to consolidate the actions is granted to the following extent: all four actions are consolidated for pretrial purposes; Rubin Baum Levin Constant & Friedman, Esqs., plaintiff's counsel in the *Marshel* action, are appointed general counsel for plaintiffs in all four cases; general counsel are directed to file a consolidated amended complaint encompassing all parties and all claims in the *Marshel, Michaels* and *Krause* cases within twenty (20) days; the *Swift* case will proceed on its original complaint.

Since the cases now pending are purported class actions, additional shareholder actions based on the same transactions will serve no useful purpose and will only confuse and delay this already complex litigation. All shareholders of Concord, therefore, shall be stayed from commencing fur-

14. *Willcox* v. *Stern, supra,* 18 N.Y.2d at 201-02.

ther actions arising out of the transactions challenged by these actions until there has been a determination, pursuant to Rule 23(c), as to whether or not these actions may proceed as class actions.[15]

Accordingly, plaintiffs' motions for preliminary injunctions and for leave to file an amended complaint are denied. Defendants' motion for consolidation, the appointment of general counsel, and a stay of additional actions is granted to the extent set forth above.

So ordered.

Dated: New York, N. Y.
June 24, 1975

LLOYD F. MACMAHON
United States District Judge

15. *Fields* v. *Wolfson,* 41 F.R.D. 329 (S.D.N.Y. 1967).

Appendix C

Judgment of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirteenth day of February one thousand nine hundred and seventy-six.

Present:

HON. J. JOSEPH SMITH
HON. PAUL R. HAYS
HON. THOMAS J. MESKILL Circuit Judges,

75-7404

ARNOLD MARSHEL,
Plaintiff-Appellant,

v.

AFW FABRIC CORPORATION, CONCORD FABRICS, INCORPORATED, ALVIN WEINSTEIN and FRANK WEINSTEIN,
Defendants-Appellees.

BARRY L. SWIFT,
Plaintiff-Appellant,

v.

CONCORD FABRICS, INCORPORATED, AFW FABRIC CORPORATION, ALVIN WEINSTEIN and FRANK WEINSTEIN,
Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is reversed in accordance with the opinion of this court with costs to be taxed against the appellees.

A. Daniel Fusaro
Clerk

By Vincent A. Carlin
Chief Deputy Clerk

Appendix D

Order and Decision of the United States Court of Appeals for the Second Circuit Denying Rehearing En Banc

UNITED STATES COURT OF APPEALS

Second Circuit

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the tenth day of March, one thousand nine hundred and seventy-six.

75-7256

S. William Green, *et al.*,
Plaintiffs-Appellants,

v.

Santa Fe Industries, Inc., *et al.*,
Defendants-Appellees.

75-7404

Arnold Marshel,
Plaintiff-Appellant,

v.

AFW Fabric Corporation, *et al.*,
Defendants-Appellees.

Barry L. Swift,
Plaintiff-Appellant,
v.

Concord Fabrics, Incorporated, *et al.,*
Defendants-Appellees.

A poll of the judges in regular active service having been taken at the request of one of them, as to whether this action should be reheard en banc, and there being no majority in favor thereof, it is

Ordered that rehearing en banc is denied.

Chief Judge Kaufman and Circuit Judge Gurfein did not participate in the poll.

Per Curiam:

This Court has denied en banc, not because we believe these cases are insignificant, but because they are of such extraordinary importance that we are confident the Supreme Court will accept these matters under its certiorari jurisdiction, as we correctly anticipated in *Eisen* v. *Carlisle & Jacquelin,* 479 F.2d 1005, 1020 (2d Cir. 1973), *vacated,* 417 U.S. 156 (1974).

Even under the best of circumstances, an en banc proceeding is often an unwieldy and cumbersome device generating little more than delay, costs, and continued uncertainty that can ill be afforded at a time of burgeoning calendars. A case in which Supreme Court resolution is inevitable should not be permitted to tarry in this Court for further intermediate action, at best, except when the views of this Court be of real benefit to the Supreme Court. And, en banc is particularly inappropriate and unsatisfactory in the cases before us, since two of our active judges are disqualified from participating. With four senior judges sitting if these cases had been en banced, the law of the circuit might well be charted with the concurrence of only a minority of the active judges—defeating the very purpose the en banc procedure is designed to serve.

Moreover, the applications for certiorari that we expect inexorably to follow our action will not reach the Supreme Court devoid of the views of the judges of this Court. In contrast to the Pentagon Papers case—where this Court convened en banc but, due to urgent considerations of time, did not write opinions—these cases will go to the Supreme Court with full and thoughtful expositions of the opposing views of several members of this Court.

Accordingly, we speed these cases on their way to the Supreme Court as an exercise of sound, prudent, and resourceful judicial administration.

Appendix E

Statutes and Rules Involved

SECURITIES EXCHANGE ACT OF 1934

15 U.S.C. §78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. §78aa. Jurisdiction of offenses and suits

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to

enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this chapter brought by or against it in the Supreme Court or such other courts.

RULES AND REGULATIONS UNDER THE SECURITIES EXCHANGE ACT OF 1934

17 C.F.R. §240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

BUSINESS CORPORATION LAW OF THE STATE OF NEW YORK

§623. Procedure to enforce shareholder's right to receive payment for shares

(a) A shareholder intending to enforce his right under a section of this chapter to receive payment for his shares if the proposed corporate action referred to therein is taken shall file with the corporation, before the meeting of shareholders at which the action is submitted to a vote, or at such meeting but before the vote, written objection to the action. The objection shall include a statement that he intends to demand payment for his shares if the action is taken. Such objection is not required from any shareholder to whom the corporation did not give notice of such meeting in accordance with this chapter or where the proposed action is authorized by written consent of shareholders without a meeting.

(b) Within ten days after the shareholders' authorization date, which term as used in this section means the date on which the shareholders' vote authorizing such action was taken, or the date on which such consent without a meeting was obtained from the requisite shareholders, the corporation shall give written notice of such authorization or consent by registered mail to each shareholder who filed written objection or from whom written objection was not required, excepting any who voted for or consented in writing to the proposed action.

(c) Within twenty days after the giving of notice to him, any shareholder to whom the corporation was required

to give such notice and who elects to dissent shall file with the corporation a written notice of such election, stating his name and residence address, the number and classes of shares as to which he dissents and a demand for payment of the fair value of his shares. Any shareholder who elects to dissent from a merger under section 905 (Merger of subsidiary corporation) or paragraph (c) of section 907 (Merger or consolidation of domestic and foreign corporations) shall file a written notice of such election to dissent within twenty days after the giving to him of a copy of the plan of merger or an outline of the material features thereof under section 905.

(d) A shareholder may not dissent as to less than all of the shares, as to which he has a right to dissent, held by him of record, that he owns beneficially. A nominee or fiduciary may not dissent on behalf of any beneficial owner as to less than all of the shares of such owner, as to which such nominee or fiduciary has a right to dissent, held of record by such nominee or fiduciary.

(e) Upon filing a notice of election to dissent, the shareholder shall cease to have any of the rights of a shareholder except the right to be paid the fair value of his shares and any other rights under this section. A notice of election may be withdrawn by the shareholder at any time before an offer is made by the corporation, as provided in paragraph (g), to pay for his shares. After such offer, withdrawal of a notice of election shall require the written consent of the corporation. If a notice of election is withdrawn, or the proposed corporate action is abandoned or rescinded, or a court shall determine that the shareholder

is not entitled to receive payment for his shares, or the shareholder shall otherwise lose his dissenter's rights, he shall not have the right to receive payment for his shares and he shall be reinstated to all his rights as a shareholder as of the filing of his notice of election, including any intervening preemptive rights and the right to payment of any intervening dividend or other distribution or, if any such rights have expired or any such dividend or distribution other than in cash has been completed, in lieu thereof, at the election of the corporation, the fair value thereof in cash as determined by the board as of the time of such expiration or completion, but without prejudice otherwise to any corporate proceedings that may have been taken in the interim.

(f) At the time of filing the notice of election to dissent or within one month thereafter the shareholder shall submit the certificates representing his shares to the corporation, or to its transfer agent, which shall forthwith note conspicuously thereon that a notice of election has been filed and shall return the certificates to the shareholder or other person who submitted them on his behalf. Any shareholder who fails to submit his certificates for such notation as herein specified shall, at the option of the corporation exercised by written notice to him within forty-five days from the date of filing of such notice of election to dissent, lose his dissenter's rights unless a court, for good cause shown, shall otherwise direct. Upon transfer of a certificate bearing such notation, each new certificate issued therefor shall bear a similar notation together with the name of the original dissenting holder of the shares and a

transferee shall acquire no rights in the corporation except those which the original dissenting shareholder had after filing his notice of election.

(g) Within seven days after the expiration of the period within which shareholders may file their notices of election to dissent, or within seven days after the proposed corporate action is consummated, whichever is later (but in no case later than ninety days from the shareholders' authorization date), the corporation or, in the case of a merger or consolidation, the surviving or new corporation, shall make a written offer by registered mail to each shareholder who has filed such notice of election to pay for his shares at a specified price which the corporation considers to be their fair value. If the corporate action has not been consummated upon the expiration of the ninety day period after the shareholders' authorization date, the offer may be conditioned upon the consummation of such action. Such offer shall be made at the same price per share to all dissenting shareholders of the same class, or if divided into series, of the same series and shall be accompanied by a balance sheet of the corporation whose shares the dissenting shareholder holds as of the latest available date, which shall not be earlier than twelve months before the making of such offer, and a profit and loss statement or statements for not less than a twelve month period ended on the date of such balance sheet or, if the corporation was not in existence throughout such twelve month period, for the portion thereof during which it was in existence. If within thirty days after the making of such offer, the corporation making the offer and any shareholder agree upon the

price to be paid for his shares, payment therefor shall be made within sixty days after the making of such offer or the consummation of the proposed corporate action, whichever is later, upon the surrender of the certificates representing such shares.

(h) The following procedure shall apply if the corporation fails to make such offer within such period of seven days, or if it makes the offer and any dissenting shareholder or shareholders fail to agree with it within the period of thirty days thereafter upon the price to be paid for their shares:

(1) The corporation shall, within twenty days after the expiration of whichever is applicable of the two periods last mentioned, institute a special proceeding in the supreme court in the judicial district in which the office of the corporation is located to determine the rights of dissenting shareholders and to fix the fair value of their shares. If, in the case of merger or consolidation, the surviving or new corporation is a foreign corporation without an office in this state, such proceeding shall be brought in the county where the office of the domestic corporation, whose shares are to be valued, was located.

(2) If the corporation fails to institute such proceeding within such period of twenty days, any dissenting shareholder may institute such proceeding for the same purpose not later than thirty days after the expiration of such twenty day period. If such proceeding is not instituted within such thirty day period, all dissenter's rights shall

be lost unless the supreme court, for good cause shown, shall otherwise direct.

(3) All dissenting shareholders, excepting those who, as provided in paragraph (g), have agreed with the corporation upon the price to be paid for their shares, shall be made parties to such proceeding, which shall have the effect of an action quasi in rem against their shares. The corporation shall serve a copy of the petition in such proceeding upon each dissenting shareholder who is a resident of this state in the manner provided by law for the service of a summons, and upon each nonresident dissenting shareholder either by registered mail and publication, or in such other manner as is permitted by law. The jurisdiction of the court shall be plenary and exclusive.

(4) The court shall determine whether each dissenting shareholder, as to whom the corporation requests the court to make such determination, is entitled to receive payment for his shares. If the corporation does not request any such determination or if the court finds that any dissenting shareholder is so entitled, it shall proceed to fix the value of the shares, which, for the purposes of this section, shall be the fair value as of the close of business on the day prior to the shareholders' authorization date, excluding any appreciation or depreciation directly or indirectly induced by such corporate action or its proposal. The court may, if it so elects, appoint an appraiser to receive evidence and recommend a decision on the question of fair value. Such appraiser shall have the power, authority and duties

specified in the order appointing him, or any amendment thereof.

(5) The final order in the proceeding shall be entered against the corporation in favor of each dissenting shareholder who is a party to the proceeding and is entitled thereto for the value of his shares so determined.

(6) The final order shall include an allowance for interest at such rate as the court finds to be equitable, from the shareholders' authorization date to the date of payment. If the court finds that the refusal of any shareholder to accept the corporate offer of payment for his shares was arbitrary, vexatious or otherwise not in good faith, no interest shall be allowed to him.

(7) The costs and expenses of such proceeding shall be determined by the court and shall be assessed against the corporation, except that all or any part of such costs and expenses may be apportioned and assessed, as the court may determine, against any or all of the dissenting shareholders who are parties to the proceeding if the court finds that their refusal to accept the corporate offer was arbitrary, vexatious or otherwise not in good faith. Such expenses shall include reasonable compensation for and the reasonable expenses of the appraiser, but shall exclude the fees and expenses of counsel for and experts employed by any party unless the court, in its discretion, awards such fees and expenses. In exercising such discretion, the court shall consider any of the following: (A) that the fair value of the shares as determined materially exceeds the

amount which the corporation offered to pay; (B) that no offer was made by the corporation; and (C) that the corporation failed to institute the special proceeding within the period specified therefor.

(8) Within sixty days after final determination of the proceeding, the corporation shall pay to each dissenting shareholder the amount found to be due him, upon surrender of the certificates representing his shares.

(i) Shares acquired by the corporation upon the payment of the agreed value therefor or of the amount due under the final order, as provided in this section, shall become treasury shares or be cancelled as provided in section 515 (Reacquired shares), except that, in the case of a merger or consolidation, they may be held and disposed of as the plan of merger or consolidation may otherwise provide.

(j) No payment shall be made to a dissenting shareholder under this section at a time when the corporation is insolvent or when such payment would make it insolvent. In such event, the dissenting shareholder shall, at his option:

(1) Withdraw his notice of election, which shall in such event be deemed withdrawn with the written consent of the corporation; or

(2) Retain his status as a claimant against the corporation and, if it is liquidated, be subordinated to the rights of creditors of the corporation, but have rights superior to the non-dissenting shareholders, and if it is not liquidated,

retain his right to be paid for his shares, which right the corporation shall be obliged to satisfy when the restrictions of this paragraph do not apply.

(3) The dissenting shareholder shall exercise such option under subparagraph (1) or (2) by written notice filed with the corporation within thirty days after the corporation has given him written notice that payment for his shares cannot be made because of the restrictions of this paragraph. If the dissenting shareholder fails to exercise such option as provided, the corporation shall exercise the option by written notice given to him within twenty days after the expiration of such period of thirty days.

(k) The enforcement by a shareholder of his right to receive payment for his shares in the manner provided herein shall exclude the enforcement by such shareholder of any other right to which he might otherwise be entitled by virtue of share ownership, except as provided in paragraph (e), and except that this section shall not exclude the right of such shareholder to bring or maintain an appropriate action to obtain relief on the ground that such corporate action will be or is unlawful or fraudulent as to him.

(l) Except as otherwise expressly provided in this section, any notice to be given by a corporation to a shareholder under this section shall be given in the manner provided in section 605 (Notice of meetings of shareholders).

(m) This section shall not apply to foreign corporations except as provided in subparagraph (e) (2) of section 907

(Merger or consolidation of domestic and foreign corporations).

§902. Plan of merger or consolidation

(a) The board of each corporation proposing to participate in a merger or consolidation under section 901 (Power of merger or consolidation) shall adopt a plan of merger or consolidation, setting forth:

(1) The name of each constituent corporation and, if the name of any of them has been changed, the name under which it was formed; and the name of the surviving corporation, or the name, or the method of determining it, of the consolidated corporation.

(2) As to each constituent corporation, the designation and number of outstanding shares of each class and series, specifying the classes and series entitled to vote and further specifying each class and series, if any, entitled to vote as a class; and, if the number of any such shares is subject to change prior to the effective date of the merger or consolidation, the manner in which such change may occur.

(3) The terms and conditions of the proposed merger or consolidation, including the manner and basis of converting the shares of each constituent corporation into shares, bonds or other securities of the surviving or consolidated corporation, or the cash or other consideration to be paid or delivered in exchange for shares of each constituent corporation, or a combination thereof.

(4) In case of merger, a statement of any amendments or changes in the certificate of incorporation of the sur-

viving corporation to be effected by such merger; in case of consolidation, all statements required to be included in a certificate of incorporation for a corporation formed under this chapter, except statements as to facts not available at the time the plan of consolidation is adopted by the board.

(5) Such other provisions with respect to the proposed merger or consolidation as the board considers necessary or desirable.

§903. Authorization by shareholders

(a) The board of each constituent corporation, upon adopting such plan of merger or consolidation, shall submit such plan to a vote of shareholders in accordance with the following:

(1) Notice of meeting shall be given to each shareholder of record, as of the record date fixed pursuant to section 604 (Fixing record date), whether or not entitled to vote. A copy of the plan of merger or consolidation or an outline of the material features of the plan shall accompany such notice.

(2) The plan of merger or consolidation shall be adopted at a meeting of shareholders by vote of the holders of two-thirds of all outstanding shares entitled to vote thereon. Notwithstanding any provision in the certificate of incorporation, the holders of shares of a class or series shall be entitled to vote and to vote as a class if the plan of merger or consolidation contains any provision which, if contained

in an amendment to the certificate of incorporation, would entitle the holders of shares of such class or series to vote and to vote as a class thereon. In such case, in addition to the authorization of the merger or consolidation by vote of the holders of two-thirds of all outstanding shares entitled to vote thereon, the merger or consolidation shall be authorized by vote of the holders of a majority of all outstanding shares of each such class or series.

(b) Notwithstanding shareholder authorization and at any time prior to the filing of the certificate of merger or consolidation, the plan of merger or consolidation may be abandoned pursuant to a provision for such abandonment, if any, contained in the plan of merger or consolidation.

§910. Right of shareholder to receive payment for shares upon merger, consolidation or sale, lease, exchange or other disposition of assets

(a) A shareholder of a domestic corporation shall, subject to and by complying with section 623 (Procedure to enforce shareholder's right to receive payment for shares), have the right to receive payment of the fair value of his shares and the other rights and benefits provided by such section, in the following cases:

(1) Any shareholder entitled to vote who does not assent to the taking of an action specified in [subparagraph (A)] * * *

(A) Any plan of merger or consolidation to which the corporation is a party * * *

* * *

Appendix F

Opinion of the Supreme Court of the State of New York

SUPREME COURT : NEW YORK COUNTY

SPECIAL TERM : PART I

Index No. 40678-1975

PEOPLE OF THE STATE OF NEW YORK,
Plaintiffs,

against

CONCORD FABRICS, INC., AFW FABRIC CORP., ALVIN WEINSTEIN, FRANK WEINSTEIN, and DAVID R. CAPLAN,
Defendants.

JACOB MARKOWITZ, J.:

This is a motion by the State of New York for an injunction, pendente lite, seeking in effect to prevent the effectuating of a corporate merger. Defendant Concord Fabrics, Inc., a New York corporation, went "public" in 1968 with the sale of $4,500,000 worth of common stock. The following year, a second issue was offered to the public which brought in an additional $4,000,000. The book value of the publicly-offered shares varied at the time of the offerings between $6.75 and $7.15 a share. The market price declined from a high of $25.00 a share to about $1.00 a share at the end of 1974. Some time in 1974, the indi-

vidual defendants decided to go "private" and return full ownership and control of the shares in the corporation to the Weinstein family. To accomplish this purpose, the Weinstein group formulated a new corporation called AFW Fabric Corp. At that time the Weinstein group, through personal ownership and through trusts they controlled as fiduciaries, represented 68 per cent of the outstanding shares of Concord. These shares were transferred to AFW. In turn AFW transferred its total outstanding stock to the Weinstein group.

About the same time, the Weinstein's engaged the underwriting firm of Shearson Hayden Stone Inc. to render an appraisal for a proposed tender-offering merger. The appraisal resulted in a figure of $3.00 a share. It appears that the appraiser was the son of a director of Concord. In early February of this year, a tender offer was actually made to the public shareholders of Concord by AFW. Litigation which ensued, however, forced withdrawal of the tender offer. Instead, a notice of meeting was called by Concord to approve a plan of merger at a meeting scheduled for April 10, 1975. The proxy statement, accompanying the notice, unabashedly states that the purpose of the proposed merger of AFW into Concord "is to return the Company to the status of a privately-held corporation owned by the Weinstein family. Upon consummation of the merger, the Weinstein's will be the sole stockholders and directors of the Company, and will thus be able to determine all policies of the Company, such as salaries for themselves and others, dividends and business activities, without public scrutiny and solely with regard

to their own interests." The plan also advised minority shareholders that they must either accept $3.00 per share for their stock, or resort to judicial proceedings as contemplated under section 910 of the Business Corporation Law for appraisal of their holdings. It is also stated in the plan of merger that

> "AFW owns more than the percentage of the Company's Common Stock required to approve the merger and intends to vote such stock in favor of the merger. Accordingly, the other shareholders of the Company will be unable to defeat approval of the merger by voting against it and thus may either accept $3 per share in cash or exercise their appraisal rights."

Upon completion of the merger, AFW's corporate existence will cease. The merger plan is to be financed by credit advanced to Concord.

The sole issue here is whether the State has an interest in investigating and seeking to have vitiated a proposed merger or freeze out of minority stockholders under its police power, where proper grounds exist.

Under Federal law, it has been generally held that minority stockholders in freeze-out situations are relegated to their right of appraisal where a corporate purpose in going private is shown and where there has been full disclosure (Dreier v. The Music Makers Group, Inc., [SDNY, 2/20/74] CCH Fed. Securities Law Reporters, ¶94,406; Tanzer Economic Associates v. Haynie [SDNY, 11/20/74 Civ. 4854], CCH Fed. Securities Law Reporters, ¶94,873; cf. Albright v. Bergendahl [DC Utah, 9/5/74], CCH Fed. Securities Law Reporters, ¶94,997).

This treatment of minority stockholders has been severely criticized by a U.S. Security and Exchange Commissioner in a speech wherein he stated

> "Faced with the prospect of a force-out merger, or a market reduced to glacial activity and the liquidity of the Mojave Desert and deprived of most of the benefits of the * * * securities laws, how real is the choice of the shareholder confronting the offer of management to acquire his shares, usually not with their own resources, but with the corporation's resources that really belong to him and his fellow shareholders?" (A.A. Sommer, Jr. "Going Private": A lesson in corporate responsibility.)

The SEC has sought to inject standards of fairness through the application of Federal securities laws. However, these laws do not seem sufficiently broad to deal with the problem of going private.

In this state, the fiduciary relation between managing stockholders and controlling stockholders and minority stockholders has long been recognized (Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185).

The Court in Kavanaugh, supra, upheld a cause of action based upon an inference that those in control "conceived and progressed the scheme of dissolving the corporation, irrespective of the welfare or advantage of the corporation and of any cause or reason related to its condition or future, through the desire and determination to take from the corporation and to secure to themselves the corporate business, freed from interference or participation on the part of the plaintiff." (p. 197)

In Blumenthal v. Roosevelt Hotel, Inc. (Supreme Court, N. Y. County, 1952), 202 Misc. 988, in a situation strikingly similar to the one at bar, it was held that where a "freeze out" of minority stockholders is attempted, the Court will relegate the dissenting shareholders to their appraisal rights where it is shown that bad faith is merely charged generally, "but otherwise the classic elements of fraud are not spelled out." (p. 989)

In reaching its conclusion, the Court in Blumenthal stated, "The principles stated in the *Kavanaugh* case (*supra*) are sound principles of law and equity, but the situation that we have in the instant case is not the same as that involved in the Kavanaugh matter." (p. 990)

Since Blumenthal, there appears to have been a broadening concept of fiduciary obligations of majority to minority stockholders, so that in Williams v. Bartell, 34 Misc 2d 553, modified 16 A D 2d 21, there appears to have been a balancing of the equities between whether dissenting shareholders must be relegated to actions at law or obtain relief in equity, depending on the peculiar circumstances and exigencies of a given situation.

The instant proceeding is brought not by individuals, but under article 23A of the General Business Law, which is commonly known as the Martin Act, or the New York State "Blue Sky Law." Section 352 of the General Business Law empowers the Attorney General

> "Whenever it shall appear to the attorney-general, either upon complaint or otherwise, that * * * in the issuance, exchange, purchase, sale, promotion, negotiation, advertisement, investment advice or distribu-

> tion within or from this state, of any stocks, bonds, notes, evidences of interest or indebtedness or other securities * * * any person, partnership, corporation, company, trust or association * * * shall have employed or employs, or is about to employ, any device, scheme or artifice to defraud or for obtaining money or property by means of any false pretense, representation or promise, or that any person, partnership, corporation, company, trust or association, or any agent or employee thereof shall have made, makes or attempts to make, within or from this state, fictitious or pretended purchases or sales of securities or commodities or that any person, partnership, corporation, company, trust or association or agent or employees thereof shall have employed, or employs, or is about to employ, any deception, misrepresentation, concealment, suppression, fraud, false pretense or false promise, or shall have engaged in or engages in or is about to engage in any practice or transaction or course of business relating to the purchase, exchange, investment advice or sale of securities or commodities which is fraudulent or in violation of law and which has operated or which would operate as a fraud upon the purchase * * * any one or all of which devices, schemes, artifices, fictitious or pretended purchases or sales of securities or commodities, deceptions, misrepresentations, concealments, suppressions, frauds, false pretenses, false promises, practices transactions and courses of business are hereby declared to be and are hereinafter referred to as fraudulent practice or fraudulent practices. * * *"

Where such investigation uncovers to the satisfaction of the Attorney General that barred practices have been engaged in, he is authorized under Section 353 of the Gen-

eral Business Law to bring an action in the name and on behalf of the People of the State to enjoin such allegedly "fraudulent practices." Paternalistic in its design, the Martin Act was adopted to protect the public against exploitation by visionary schemes and other fraudulent practices respecting stocks, bonds and other securities (People v. Federated Radio Corp., 244 N.Y. 33; People v. Tellier, 7 Misc 2d 43).

The fraudulent practices, which are the target of the Martin Act, need not be fraud in the classic sense since, pursuant to the Act, the absence of scienter or intent to defraud does not relieve a defendant from liability (People v. Federated Radio Corp., supra; People v. Royal Securities Corp., 5 Misc 2d 907).

It would thus appear that under the broad powers afforded the Attorney General, under Article 23A of the General Business Law, the security transactions such as are involved in this proceeding are proper targets for his scrutiny despite the fact that full disclosure of the aims of the Weinstein group have been articulated. What is disquietingly evident here is the fact that a group of insiders who are directing the reacquisition program, even controlling the appraisal of the stock are the very ones who made the company public originally, and will be the surviving shareholders in the proposed privately-held enterprise. Adding to the odium of the scheme is that fact that no real corporate purpose has been demonstrated and that the credit of a now public corporation will be used to finance a merger for the benefit of a private group.

Equity mandates fairness in all human transactions. In this state, the legislature has seen fit to empower the Attorney General to scrutinize security transactions so that wrong may be averted and that the small investor will not be prey to a self-interested majority either in going public or private. For this reason the motion for temporary injunction is in all respects granted.

Settle order.

Dated: June 11, 1975.

S/ JM
J. S. C.